

STATE OF MAINE  
PUBLIC UTILITIES COMMISSION

Docket No. 99-411

December 2, 1999

CMP GROUP, INC. ET AL  
Request for Approval of Reorganization  
And of Affiliated Interest Transactions

EXAMINER'S REPORT

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NOTE: This Report contains the recommendation of the Advisory Staff and is in draft order format. Parties may file responses or exceptions to this Report on or before **December 9, 1999**. It is expected that the Commission will consider this report at its deliberative session on **December 16, 1999**.

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**I. SUMMARY**

This Examiner's Report presents two alternative recommendations: 1) approval with conditions; 2) denial without prejudice to Petitioners refiling with additional cost savings information or for consideration following a complete review of its ARP 2000 proposal.

**II. PROCEDURAL HISTORY**

On June 14, 1999, CMP Group, Inc. (CMP Group), Central Maine Power Company (CMP), MaineCom Services, Maine Electric Power Company, Inc., NORVARCO, Chester SVC Partnership, Maine Yankee Atomic Power Company and CMP Natural Gas, L.L.C. (CMPNG) (collectively, Petitioners) and Energy East Corporation (Energy East) executed a merger agreement under which CMP Group will become a wholly-owned subsidiary of Energy East. On July 1, 1999, Petitioners filed their Petition seeking approval pursuant to 35-A M.R.S.A. § 708. Included with the Petition was the Prefiled Direct Testimony of Arthur W. Adelberg and Dr. Kenneth Gordon. The Commission held a technical conference on July 7, 1999 to give

Petitioners the opportunity to make an overview presentation of the case and to allow the parties to ask preliminary questions.

The Hearing Examiner granted intervenor status to the following parties: Office of the Public Advocate (OPA), the Industrial Energy Consumer's Group (IECG), the Independent Energy Producers of Maine (IEPM), the Coalition for Sensible Energy (CSE), UAH-Hydro Kennebec Limited Partnership, the American Association of Retired Persons (AARP), FPL Energy Maine, and Friends of the Coast. Bangor Gas Company and Bangor Hydro-Electric Company were granted intervenor status on a discretionary basis pursuant to Chapter 110 § 721.

On July 13, 1999, the Hearing Examiner issued a Procedural Order requesting that Petitioners file supplemental testimony concerning the savings associated with the merger and how CMP planned to treat such savings. The Examiner also asked Petitioners to clarify how they expected the rate plan discussed at the July 7 conference to relate to this proceeding.

On July 22, 1999, Petitioners filed the Supplemental Prefiled Direct Testimony of Arthur W. Adelberg describing their position concerning the rate treatment of merger costs and savings.<sup>1</sup> At the same time, CMP Group filed a Motion to Clarify Scope of Proceeding, or in the Alternative, Appeal to the Commission. The motion asked the Hearing Examiner to confirm that rate issues related to the treatment of merger costs and savings are not part of this proceeding but are more appropriately addressed in a

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<sup>1</sup> Mr. Adelberg stated that CMP planned to file a proposed performance based rate plan to take the place of its ARP by early fall. CMP made its filing on September 30, 1999. *Central Maine Power, Request for Post-Merger Alternative Rate Plan*, Docket No. 99-666.

rate plan CMP planned to file in the near future. OPA responded to CMP's Motion on July 28, 1999.

The Hearing Examiner issued a Procedural Order on August 2, 1999, determining that specific rate making treatment is not within the scope of this proceeding. However, the Examiner found that costs and savings associated with the merger are relevant to an inquiry of whether any harms associated with a merger are outweighed by the benefits. Therefore, discovery on this area was permitted. The Examiner warned that CMP risked not meeting its burden of proof by not providing evidence of merger costs and savings.

On July 22, 1999, the IECG, OPA, IEPM and AARP jointly filed a Motion for Joinder of Energy East and a supporting Memorandum of Law. On July 29, CMP Group filed its Memorandum of Law in Opposition to the IECG's Motion. On August 6, 1999, the Hearing Examiner denied the Motion for Joinder. The Examiner did require that Energy East would be subject to discovery and would provide a witness at the hearings. Parties conducted extensive written discovery and a technical conference was held on September 2, 1999.

On September 15, 1999, the OPA filed the Direct Testimony and Exhibits of Paul Chernick and Neil Talbot. IECG filed testimony and exhibits of Dr. Richard Silkman and Raymond Shadis filed testimony for Friends of the Coast.

On September 23, 1999, CMP Group filed a Motion to Strike Portions of the Testimony of Richard Silkman related to the Letter Agreement entered into between CMP and FPL Energy Maine, Inc. and application of the findings in Docket No. 97-580, *Maine Public Utilities Commission Investigation of Central Maine Power Company's*

*Stranded Costs, Transmission and Distribution Utility Revenue Requirements, and Rate Design*, to "CMP as an affiliate of Energy East." After considering the response of IECG and FPL, the Examiner in a Procedural Order dated October 15, 1999, granted CMP's Motion to Strike those portions related to the Letter Agreement, but not to the Docket No. 97-580 findings.<sup>2</sup>

Public Witness Hearings were held on September 27 in Portland and September 29 in Waterville.

On October 13, 1999, CMP filed the Rebuttal Testimony of Arthur W. Adelberg and Kenneth Gordon. Hearings were held on November 2 and 3, 1999, for the purpose of cross-examining witnesses.

### **III. MERGER APPROVAL – LEGAL STANDARD**

The proposed merger (the purchase of all outstanding stock of CMP Group, Inc. by Energy East) constitutes a "reorganization" under 35-A M.R.S.A. § 708 and so requires Commission approval. Under this section, the Commission may approve a reorganization only if the applicant establishes that approval of the reorganization is consistent with the interests of a utility's ratepayers and investors. The Commission has previously found that the approval requirements of section 708 are met if the rates or services to customers of the former utility will not be adversely affected by the transaction. See e.g., *Consumers Maine Water Co. Request for Approval of Reorganization Due to Merger with Philadelphia Suburban Corp.*, Docket No. 98-648 (Jan. 12 1999); *New England Telephone Telegraph Company and NYNEX Corp.*

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<sup>2</sup> Page 7, lines 5-7; Page 18 lines 11-26, Page 19 lines 1-21 and Page 38 line 8 through Page 39 line 23 of Dr. Silkman's prefiled testimony were stricken.

*Reorganization Intended to Effect the Merger with Bell Atlantic*, Docket No. 96-388 (Feb. 6, 1997) (Bell Atlantic), *Bangor Hydro-Electric Company and Stonington and Deer Isle Power Company, Joint Application to Merge Property, Franchises and Permits and for Authority to Discontinue Service*, Docket No. 87-109, Order Approving Stipulation and Merger (Nov. 10, 1987); and *Greenville, Millinocket and Skowhegan Water Company, Application for Authorization to Sell Utility Property to Wanakah Water Company and to Discontinue Service*, Docket No. 92-250, Order Approving Stipulation (Dec. 15, 1992). Thus, the merger should be approved if the total benefits flowing from the merger are equal to or greater than the detriment or risks resulting from the transaction for both ratepayers and shareholders. *Bell Atlantic* at 8. As stated in section 708, the burden of proof is on the applicant to make this showing. 35-A M.R.S.A. §708 (2) (no reorganization may be approved unless it is established by the *applicant* that the reorganization is consistent with the interests of ratepayers and investors).

Given these standards, we must review the evidence presented by the Petitioners and the other parties and determine whether the benefits of the merger put forth by the Petitioners are at least equal to any potential risks, to ensure no harm to ratepayers and shareholders. Because shareholders are clearly protected by the purchase of their shares at a premium and their right to vote to approve the merger, our review will be on the impact of the reorganization on ratepayers.<sup>3</sup>

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<sup>3</sup> OPA argues that the Commission should require the Petitioners to meet a higher standard of clear and convincing evidence in showing there will be no harm to ratepayers. It urges this higher standard "because of the complete lack of specific evidence of potential savings" to offset the costs of the merger. We reject this request. OPA provides no legal support or Commission precedent for its request.

#### IV. DESCRIPTION OF PLANNED MERGER

This section briefly describes the events leading up to the proposed merger, the proposed merger and the planned accounting for the merger transaction.

During a September 1998 meeting of the affiliated company CMP Natural Gas (CMPNG), Energy East's chairman, president and chief executive officer, Wesley W. von Schack, indicated to David T. Flanagan, the president and chief executive officer of CMP Group that Energy East might be interested in a strategic combination with CMP Group. No further conversations were held until February 1999, when Mr. von Schack expressed a continuing interest.<sup>4</sup>

CMP Group engaged the services of SBC Warburg Dillon Read LLC to act as CMP Group's exclusive financial advisor and Thelen Reid & Priest LLP to act as CMP Group's legal counsel. Following a special board meeting on February 18, 1999, the CMP Group board of directors instructed management to investigate a merger or sale of the Company.

In March 1999, Energy East and CMP Group continued discussions of a potential combination. On April 29, 1999, Energy East submitted a draft proposal and invited CMP Group to negotiate in the context of that proposal. During this process, SBC Warburg Dillon Read, on behalf of CMP Group, developed a list of other prospective merger partners and began confidential inquiries with respect to those other companies. Energy East and two of the other companies signed confidentiality agreements to allow the review of financial and other relevant information.

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<sup>4</sup> The information in this and the following five paragraphs is based upon information included in the CMP Group Proxy Statement provided in response to IECG-02-01.

On May 20, 1999, the CMP Group board of director's instructed management and Warburg Dillon Read to solicit final determinative bids from the three potential merger partners. The bids were to include the amount and type of consideration to be received by CMP Group shareholders as well as any material conditions or obstacles the bidders had identified to completion of a merger. The bids were submitted by May 24, 1999. The board of directors, along with SBC Warburg Dillon Read and Thelen Reid & Priest, met on May 25, 1999 to consider the bids.

In terms of the amount of consideration offered, the Energy East bid was equal to the higher of the other two bids. The CMP Group board of director's decided to pursue negotiations with Energy East on an exclusive basis. On May 27, 1999, CMP Group executed an agreement to negotiate exclusively with Energy East for a two-week period and suspended its discussions with the other two bidders.<sup>5</sup>

On June 14, 1999, the CMP Group board of directors held a special meeting to review the terms of the final proposed merger agreement and related transactions. The board of directors approved the proposed merger agreement and the transactions it described at this meeting. On June 15, 1999, the merger was publicly announced. At a special meeting on October 7, 1999, CMP Group shareholders approved the merger.

The merger proposal would result in a cash payment to shareholders of \$29.50 per share. In addition, the transaction included employment contracts for David T.

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<sup>5</sup> Energy East also entered into merger agreements effective April 23, 1999 and June 29, 1999 with Connecticut Energy and CTG Resources, respectively. Both companies would become wholly owned subsidiaries of Energy East. In addition, on November 10, 1999, Energy East announced that it has reached an agreement with Berkshire Energy Resources under which Energy East would acquire all of the common shares of Berkshire.

Flanagan, Arthur W. Adelberg, Sara J. Burns, and F. Michael McClain, Jr. The transaction results in a total payment of approximately \$957 million for all of the outstanding common stock of CMP Group. CMP Group has estimated that the book value of its common stock equity at the transaction's close will be approximately \$541.5 million, approximately 77% more than book value. The estimated transaction costs are approximately \$6.5 million to \$7 million for CMP Group and approximately \$11 million for Energy East. The difference between the purchase price and the book value plus Energy East's transaction costs is the preliminary goodwill amount.<sup>6</sup>

Near the time of closing, Energy East plans to revalue CMP Group's non-regulated subsidiaries (MaineCom Services, NORVARCO, and Chester SVC Partnership) to their current market values and record the appropriate adjustment to the books and records of each subsidiary. Any difference between the book value of these companies and the established market value will be adjusted from the total goodwill amount. The net of the preliminary goodwill and the amount allocated to the non-regulated subsidiaries will be considered goodwill for Central Maine Power Company.<sup>7</sup> This amount will be subject to a maximum amortization period of 40 years under Generally Accepted Accounting Principles (GAAP). CMP will record the goodwill in Account 114, Electric Plant Acquisition Adjustments. The amortization will be expensed

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<sup>6</sup> Goodwill and acquisition premium/adjustment have been used interchangeably during the course of this case. Goodwill is the terminology used in Generally Accepted Accounting Principles (GAAP) where Acquisition Premium/Adjustment is the term used in regulatory settings. Essentially both mean the difference between the purchase price and book value of an asset.

<sup>7</sup> Energy East has indicated that it is unsure as to whether any goodwill would be allocated to CMP Natural Gas as part of this transaction. Tr. at H154-155.



below the line in Account 425, Miscellaneous Amortization on a straight-line basis over the 40-year amortization period. CMP has acknowledged that the GAAP requirements do not bind this Commission when it determines the ratemaking effect and treatment of these items.

## **V. POSITION OF PARTIES**

### **A. Petitioners**

Petitioners claim that the merger will cause no adverse effects on service quality or rates and that total benefits exceed any risks. With regard to service quality, Petitioners claim that CMP's past performance has been superior and that Energy East has a reputation and a commitment to excellent customer service. CMP and Energy East claim they will maintain CMP's existing service quality and reliability targets in any future ARP.

With regard to rates, CMP has not included any of the costs of the merger or costs of achieving merger synergies in this case or in its current rate case (Docket No. 97-580). Because rates are being set without considering the merger, Petitioners argue there will be no adverse effect on rates due to the merger.

Other benefits claim Petitioners to derive from the merger include: fewer financial risks for CMP as part of a larger company; access to greater management experience; sharing of best practices; and a heightened focus on economic development. Petitioners argue these more than offset the risks raised by other parties (e.g. affiliate abuses; increased financial risk for CMP; management inattention to core

business; diversification.<sup>8</sup>

With regard to recovery of the acquisition premium being paid by Energy East, Petitioners ask the Commission to affirm in its order approving this merger “[t]he principle that Energy East will be accorded a reasonable opportunity to recover the acquisition premium through net synergies achieved by the merger.”

The Petitioners also ask that the Commission remove three restrictions imposed as part of CMP’s reorganization in Docket Nos. 97-930 and 98-077: restrictions on investment, limits on debt issuance and payment of royalties by its gas affiliate for the use of the CMP name.

B. OPA

OPA argues that the Petitioners have failed to provide sufficient evidence of potential merger cost savings to offset potential harms. Potential harms include the risk that rates will be higher; service quality and reliability will be reduced to achieve cost savings; and management will be distracted due to Energy East’s expansion into four different states.

If the Commission chooses to approve the merger, the OPA urges the Commission to reject Petitioners’ request for an explicit opportunity for the future recovery of an acquisition adjustment. OPA argues that the ARP 2000 proceeding will allow an opportunity to consider this issue; any pronouncement now will set a dangerous precedent for future mergers and such assurance would not address how

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<sup>8</sup> CMP claims the largest benefit comes from being able to “offer” its proposed ARP 2000 rate plan. Since that plan is not in this case and no discovery or review of it has taken place, we will not consider the terms of CMP’s specific proposal in weighing the potential benefits and risks associated with the merger.

such recovery would be treated in years after ARP 2000 expires.

Further, the OPA proposes four conditions: maintaining CMP Group's \$240 million investment limit on future investments in non-utility activities; continuing the royalty payment by CMPNG to CMP pursuant to the stipulation approved in Docket No. 98-077; continuing CMP Group's debt limitation at 50% of total capitalization; and making no reference to the future recovery in rates of any acquisition premium.

C. IECG

IECG argues that the Petitioners have failed to show how many substantial risks to ratepayers will be mitigated by any benefits. Risks include potential negative impacts on rates; less attention to Maine ratepayers from management; fewer employees leading to decreased service quality; less capital investment; and increased difficulty in regulating CMP as part of multi-state holding company. IECG claims any offsetting benefits, including any possible merger savings claimed by Petitioners, are too vague and are not verifiable.

IECG argues that unless stringent conditions are imposed, the Commission should deny approval of the merger. These conditions include: not allowing any implicit or explicit recovery of an acquisition premium; flowing any savings related to the provision of electricity service directly to CMP's ratepayers; imposing the existing ARP performance criteria related to service quality with a graduated penalty system; setting annual capital expenditure target levels; requiring the consideration of merger costs and savings as part of any new ARP; and requiring acknowledgement by Energy East of the Commission's findings in Docket No. 97-580 (Phases I and II).

IECG further argues the Commission should lift the investment and debt limits imposed in Docket No. 97-930; keep the royalty payment; require the filing of copies of SEC reports with the Commission; not grant blanket reorganization approval,<sup>9</sup> allow dissolution of CMP Group if required by the SEC; and allow for revisiting conditions in the event the Public Utility Holding Company Act (PUHCA) is repealed.

D. Friends of the Coast – Opposing Nuclear Pollution

The Friends of the Coast ask the Commission to stay approval of the proposed merger until CMP Group and Energy East have demonstrated that the proposal includes a fully informed plan to address decommissioning and waste storage issues at Maine Yankee Atomic Power Station (MYAPS) and related public and community issues. The Friends of the Coast also request that the Commission withhold any approval until ownership transfer issues are resolved before the Nuclear Regulatory Commission and the Federal Energy Regulatory Commission.

E. Coalition for Sensible Energy

The Coalition for Sensible Energy requests that the Commission disallow the merger unless certain conditions related to public information, energy management, quality of service and communications are made part of the Commission's decision. The CSE requests that these conditions be imposed to satisfy its concern that none of the parties in the new entity expressed any interest in the "public good" at either the technical conference or hearing.

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<sup>9</sup> Petitioners in their brief make no mention of this request. We therefore do not consider it here.

F. Independent Energy Producers of Maine

IEPM urges the Commission to reject the merger as the record does not support a finding that the merger is in the public interest as neither CMP Group nor Energy East has demonstrated that merger-related savings will exceed merger transaction costs and the acquisition premium. If the Commission does find the merger to be in the public interest, the IEPM recommends that the risk of merger costs exceeding merger-related savings be borne by the acquiring company. If the merger-related savings do not exceed the merger costs, including the acquisition premium, the shareholders should not recover any deficit or shortfall from ratepayers. The IEPM also argues that the ratepayer protections adopted in Docket No. 97-930 should not be eliminated as part of the merger.

**VI. DISCUSSION**

As described above in Section III, we must consider whether the benefits of the merger as put forth by the Petitioners are at least equal to any potential risks. Those benefits and risks are discussed below.

A. Benefits

1. Cost Savings

One of the primary reasons often put forward in favor of mergers is that it is generally less expensive for a larger utility to provide service than for a smaller one. The record in this case includes suggestions from both the Petitioners, in testimony from Dr. Gordon, and the IECG, through Dr. Silkman's testimony, that they generally expect that the merger will result in lower costs. But neither of those

witnesses, nor any others in this case, has performed any analysis of the likely range of possible savings or even the areas of the business where savings are likely.

Apparently, CMP and Energy East have simply assumed that because other similar mergers have produced savings in the range of five percent of non-fuel operations and maintenance costs, they could expect to achieve a similar level of savings. In fact, Energy East indicated that this simple rule of thumb was all that was necessary to justify their decision to offer a premium of roughly 77% over book value for CMP common stock. Petitioners argue that studies which attempt to estimate cost savings stemming from mergers are inherently uncertain and, as a result, do little more than waste resources in a “costly battle of experts” over the likely level of savings. We view this argument to be correct, at least, in part.

The fact that competing studies of cost savings might be expensive is not particularly disturbing given that this transaction involves upwards of \$1 billion. We note that much of the \$18 million in transaction costs for CMP Group and Energy East was for fairness opinions to consider whether the deal was in the interests of their respective stockholders. Rather, the problem is that even the best study of potential merger savings would likely have a large margin for error, thus limiting its ultimate usefulness.

More troubling than the lack of a reasonable cost savings<sup>10</sup> estimate is the apparent absence (at least in the record before us), of a reasonably specific plan to either determine what cost centers are likely candidates for efficiency

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<sup>10</sup> Apparently, a joint committee of CMP and Energy East personnel will consider these issues at some point in time, although the record in this case does not include any work that they might have undertaken to this point.

savings.” It is reasonable to assume a decision to invest over \$1 billion and to promise that future rates will not need to increase would have something more than an investment banker’s industry-wide “rule of thumb” as a foundation.<sup>11</sup> But Energy East represents that no such plan exists.

We do conclude that it is reasonable likely that some level of cost savings would occur as a result of the merger. However, in the absence of a reasonable estimate of possible cost savings, or a plan to achieve savings which would allow us to develop our own sense of the likely range of savings, we are left with a difficult decision. We must assess a rather expensive merger with a clearly defined cost—a purchase price far in excess of book value -- against the unspecific likelihood that some level of cost savings will occur.

## 2. Sharing of Best Practices and Personnel

The Petitioners indicated that the proposed mergers will provide benefits to consumers by allowing CMP access to “greater management experience, sharing of best practices and heightened focus on economic development.” The Petitioners also indicated that mergers have the potential to provide benefits through “economies from specialization.” They further asserted that a larger organization would give employees broader professional opportunities, thus improving morale and efficiency.

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<sup>11</sup> Magnifying this concern is the fact that the combined value of all four of Energy East’s recently, announced acquisitions, including purchases of common stock and assumption of debt and preferred stock, amounts to more than \$2.56 billion based on Company press releases and published accounts.

The other parties argue that these potential benefits are amorphous, insufficiently supported and have not been quantified. Specifically, the IECG noted that no plan for the sharing of best practices had been developed. The IECG also suggested that Energy East's statements contradict CMP's assertion that it will have the benefit of Energy East's management.

While we agree that, on a theoretical basis, mergers have the potential to produce such benefits, actually realizing these benefits depends both on the individual characteristics of the corporations and their respective managements. We agree with the intervening parties that the Petitioners have not provided sufficient specificity to determine whether or not such benefits are likely to be achieved as a result of this particular merger. Therefore, we give little weight to this evidence as support for potential benefits as a basis for approving the merger.

### 3. Access to Capital

The Petitioners argue that one benefit of the merger is that CMP will have better access to capital markets at lower costs. We agree that theoretically there maybe some benefits to be realized when a securities issuer is larger because there are fixed issuance costs for both debt and equity securities. However, given the specific circumstances of CMP and Energy East today, these appear remote. Energy East is expected to have a total capitalization in the \$4.1 to \$4.8 billion range when all four of its pending mergers are closed, while CMP Group's total capitalization was in the area of \$8.1 million at September 30, 1999. To the extent that Energy East would be able to coordinate its public issuances of debt and equity to meet future capital requirements of all its subsidiaries simultaneously, it may then be able to do larger, less



frequent issuances, thereby spreading its fixed issuance costs over a larger base. To illustrate an order of magnitude, evidence provided in *Maine Public Utilities Commission, Investigation of Stranded Cost Recovery Transmission and Distribution, Utility Revenue Requirements, and Rate Design of Bangor Hydro-Electric Co.*, Docket No. 97-596, and *Maine Public Utilities Commission Investigation of Central Maine Power Company's Stranded Costs, Transmission and Distribution Utility Revenue Requirements, and Rate Design*, Docket No. 97-580 (Phase I), indicated that fixed costs of recent common equity issuances for electric utilities ranged between \$115,000 and \$500,000 and averaged roughly \$230,000. Obviously, the ability to go from a (hypothetical) issuance of \$50 million to \$100 million will reduce the effective cost of new capital. In this example, the fixed cost as a percent of proceeds would fall from 46 basis points to 23. The effect would be similar for debt issuances although the absolute dollar savings would be smaller as debt issuances are generally not as costly as new equity issuances.

While we believe these potential benefits to be real, we are aware that future capital costs could either remain the same, or even increase following the merger. Capital costs for both debt and equity securities could remain unchanged for the following reasons. To the extent that Energy East subsidiaries wished to issue secured debt, such issuances would likely be done from the operating company level, since we would not allow the holding company to pledge utility assets as collateral. This means that the CMP would issue new debt in similar amounts at similar cost rates whether or not the merger occurs. While it might be possible for a larger Energy East to negotiate lower fixed issuance costs on secured debt or to instead utilize unsecured

debt from the holding company level, these potential benefits are speculative.

Regarding future common equity issuances, there is little doubt that larger issuances will indeed occur in the future. However, the question is: how far into the future would such benefits be realized? Both Energy East and CMP Group, following the divestiture of their generation assets, have relatively high equity ratios (51% & 72% respectively at 9/30/99), indicating that new equity issuances are not in either company's near-term plans. In fact, despite its recent acquisitions, Energy East apparently remains committed to share repurchases.

Moody's acknowledged the possibility of higher capital costs in its June 30, 1999 report on Energy East following its merger announcement with CTG Resources in Connecticut, noting:

[W]e will continue to evaluate the financial policies that Energy East might pursue for each of the utility subsidiaries in the future. A marked change toward more aggressive financial policies than those currently contemplated could add pressure on the ratings of any one or more of the companies.

In the same report, Moody's mentioned that one of Energy East's new subsidiaries, Southern Connecticut Gas Company (SCG) could experience a ratings downgrade from A2 to A3 because Energy East and SCG's soon-to-be sister subsidiaries were currently rated at A3. We are not overly concerned that this situation will have a negative impact on CMP at this time for several reasons. First, because CMP currently has an A3 bond rating from Moody's, it would not be looking at a downgrade resulting from the merger. Second, the holding company structures used by Energy East and CMP serve to insulate the utility subsidiaries to some degree from non-regulated investments that may be more risky than distribution businesses, a factor also noted by Moody's. Because

Commission approval is required for a utility to encumber (or “mortgage”) its assets, we would be able to monitor the financial conditions at the utility level in a post-merger sanario. Overall, while the possibility of improved access to capital for a post-merger CMP exists, the timing and size of the potential benefits are uncertain and thus we do not weigh this factor heavily in our final decision.

B. Risks Other Than Those Associated with the Acquisition Adjustment

In addition to the risk associated with potentially allowing the acquisition adjustment into rates (which is discussed below in C), the intervenors raise a number of other potential areas of risk. Interestingly, in a mirror image of the intervenors' criticism of Petitioner's assertion of benefits, Petitioners argues that the Commission should put no value in the intervenors' assertions of risk as they are unsubstantiated and not specific to this particular merger. We agree that potential risks cannot be identified definitely. However, section 708 requires that in order to approve the merger, we must determine that no net harm will result to ratepayers. To assure ourselves of that, we must evaluate these risks, determine their likelihood, and decide the need to impose conditions to alleviate them, if we approve the merger.

1. Reliability and Customer Service

Several parties raised concerns that the merger could result in a deterioration of customer service. The IECG and CSE noted that for the merger to produce savings, it is likely that the workforce at CMP will be reduced and that this could result in a reduction in service quality. The IECG points out that CMP has already reduced its work force significantly since the early 1990s and that further cuts may be detrimental.

We agree that maintaining a high standard of service quality is very important. Further, as demonstrated by recent experiences with Bell-Atlantic-Maine (See Docket No. 98-808, *Bell Atlantic-Maine Notice of Merger with GTE Corporation, Order on Reconsideration* (Aug. 25, 1999) (noting decline in quality of service and management attention), it is a very real risk that service quality may deteriorate when a Maine utility becomes a part of a larger multi-state firm. We find this possibility substantial, real and unacceptable. Therefore, as discussed later, we could only approve this merger with certain service quality conditions.

## 2. Over-Expansion

The OPA witness, Mr. Talbot, notes that Energy East has been on a “buying binge” and that this growth strategy brings financial risk. Mr. Talbot also indicated that Energy East’s common equity ratio target of 40% is too low and that such an aggressive target is inappropriate. Messrs. Chernick and Talbot also discussed the poor track record of utilities that have invested in unregulated areas.

Mr. Adelberg responded to these assertions by suggesting that a 40% target equity ratio, while perhaps inappropriate for CMP on a stand-alone basis, is reasonable target for the larger Energy East. Mr. Adelberg also suggested that Energy East’s public statements and practices indicate that it intends to focus on energy delivery and related services, not significant, speculative unregulated ventures. Moreover, Mr. Adelberg asserts that Energy East’s larger size makes it better able to absorb risks associated with diversification than CMP alone.

We agree that there is a risk that Energy East might over expand, placing increased risk on CMP. Of course, there is no guarantee that CMP Group

would not run into similar problems absent the merger. We do note, however that Energy East's recent spate of acquisitions do suggest some basis for concern. This is one of the risks of approving the merger.

3. Attention to Maine Operations

The OPA's witness, Mr. Chernick, pointed to possibility that Energy East's management could be distracted by having service territories in four other states besides to Maine. IECG notes that CMP ratepayers will lose their two most experienced top executives, Messrs. Adelberg and Flanagan, and that the new board that will govern CMP will be dominated by NYSEG and Energy East board members, with only four members from CMP. They suggest this will reduce CMP's autonomy. IECG also argues that the fiduciary responsibilities associated with non-Maine based stockholders requires an orientation that is focused less on Maine activities and suggests that the merger may increase the tendency to invest more capital in areas with stronger economies than Maine.

As described earlier, our experience with Bell Atlantic-Maine demonstrates that there is a risk that local operations may be compromised when a Maine utility become part of a larger multi-state utility. While it is not clear that this is specifically caused by management distraction associated with multi-state operations, it certainly may be a contributing factor. Therefore, we find this to be a very real risk, and one that cannot be easily mitigated. We cannot conceive of a condition that could directly compel Energy East to focus more management attention on its Maine operations. However, service quality conditions may indirectly accomplish this end and are, therefore, even more important. Such conditions are discussed in section VII.

4. Increased Difficulty of Regulating the Merged Entity and of Monitoring Affiliated Transactions

The IECG noted that the merger will result in a significantly more complex corporate structure that will necessarily be more difficult to regulate than CMP was prior to the merger. Further, the IECG asserts that because PUHCA was instituted in response to the difficulties associated with regulating such holding companies, the potential repeal of PUHCA would further put ratepayers at risk. Mr. Adelberg asserted that 35-A M.R.S.A. § 707 and Chapter 820 are adequate protection against affiliate abuses.

We agree that the larger, more complex structure of the merged corporation will be more difficult to monitor and regulate than CMP is as a stand-alone corporation. This difficulty necessarily brings with it the risk that regulation will be more expensive and less effective at protecting ratepayers. Therefore, if this merger is to be approved, certain conditions are necessary to address this risk.<sup>12</sup> Specific conditions are discussed in section VII, below.

5. Litigation Practices

In addition to increased regulatory scrutiny and costs that would likely result from the merger, this proceeding has highlighted an additional concern regarding future difficulties and the potential for reduced cooperation in the regulatory

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<sup>12</sup> **Examiner Note: SEC preemption of the Commission ability to oversee affiliate relationships and transaction may possibly be a concern or a risk of the merger. During the September 2, 1999 technical conference, Tr. C-186-187, the Bench asked Petitioners for an analysis of whether any of the Commission's authority over reorganizations or affiliate transactions would be preempted as a result of the merger. To our knowledge this analysis was not provided. We ask that the analysis be provided in Petitioners' exceptions.**

process. This concern arises from what we perceive as a lack of reasonable diligence, consistency, and openness from Energy East in producing information and responding to written and oral questions in this case. We discuss several examples below.

Perhaps the most troubling illustration of this concern involves responses to questions about cost savings and synergies resulting from the merger. In several data responses, Energy East stated that it had not prepared any cost savings studies or analyses related to the merger, nor did it have any documents relating to the coordination or consolidation of activities among affiliates. OPA-04-03, OPA-04-06, OPA-02-05, IECG-03-08. Energy East did state that it estimated 5% savings in combined O&M expenses based on experience with other mergers, but it had no documentation of that estimate. Despite these statements, Energy East's due diligence materials contained discussions of potential cost savings and coordination among affiliates. However most of this material was inappropriately redacted, which Energy East did not make available until ordered to do so by the Hearing Examiner. Docket No. 99-411, Procedural Order (Sept. 13, 1999). In light of the obvious interest from the parties and the Bench in cost savings information, it is difficult to understand why Energy East did not reference its due diligence materials (with any disclaimers it wished regarding what the materials did, or did not, represent).

Another example involves requests for financial analyst reports. OPA-01-02, IECG-01-17. In response, Energy East provided several such documents, but failed to provide numerous other documents responsive to the requests.<sup>13</sup> In

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<sup>13</sup> One of the excluded documents was a Merrill Lynch report stating that "the Company indicated it could achieve synergies of around \$30 million . . . ." Energy East

answer to a request for an explanation of this lapse, (Docket No. 99-411 Procedural Order (Sept. 14, 1999)), Energy East submitted a letter (dated September 20, 1999) that at best shows an absence of reasonable diligence in responding to discovery and at worst calls into question Energy East's credibility.<sup>14</sup>

An additional concern involves a data response (OPA-04-04) and discussion during the September 2, 1999 technical conference regarding Energy East's proposal on recovery of the acquisition adjustment and what finding it is asking the Commission for in this case. In its response to OPA-04-04, Energy East stated it would propose a multi-year rate plan that will specify the exact recovery method. However, the response goes on to describe in some detail (with an attached illustrative schedule) the "proposed Earning Sharing Mechanism" and states "CMP will make an explicit request that the Commission make a finding in this case that will allow . . . this Earning Sharing Mechanism to be employed so that management will be appropriately incented to achieve sufficient efficiencies to benefit both customers and investors." During questioning at the technical conference that appeared to show that the mechanism did not operate as purported, Energy East stated that the mechanism was not its proposal and suggested that this should have been clear from the statement in the data response conveying its intent to file a multi-year rate plan.

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later explained that the \$30 million came from the 5% estimate derived from observations of other mergers.

<sup>14</sup> For example, the letter stated that two analyst reports on Energy East mergers with Connecticut Gas Utilities were not provided because Energy East in good faith did not believe they were requested. However, the data requests clearly referenced financial analysts reports on Energy East. Additionally, Energy East stated that it interpreted the request to be for reports in CMP Group's possession when the request specified "in the possession of the Petitioners or Energy East."



Finally, we note inconsistencies in testimony regarding the taking of notes, and retention of notes and drafts of documents. Some parties had sought notes and other documents regarding merger negotiations. During the September 2, 1999 technical conference, Mr. Jasinski stated that neither he nor Mr. von Schack kept notes of the merger negotiations. Later, Mr. Jasinski explained in detail a "corporate policy" that is "rigorously followed" whereby notes and drafts are not retained. However, during the November 2, 1999 hearing, Mr. Jasinski testified that he may have kept notes of the negotiations, but that he did not currently have them. He also stated that there is no corporate policy on keeping notes and drafts, but there is a document retention policy that states that important documents should be kept and periodically files should be cleaned out.

By recounting these matters, we do not accuse Energy East of any intentional misconduct. These lapses may have resulted from some combination of misunderstandings of how the regulatory process is conducted in Maine, general confusion, carelessness, or overly literal readings of information requests. When concerns were raised, Energy East did provide explanations, but these generally appeared confusing, inconsistent or inadequate. Taken as a whole, the litigation activities of Energy East maybe indicative of a pattern of behavior and they raise concerns regarding the continuation of good faith cooperation we have historically observed with CMP. Thus, we conclude that the proposed merger presents a future risk of reduced cooperation regarding the regulatory process and increased costs and efforts necessary for regulatory oversight.

## C. Rates and the Acquisition Premium

### 1. Overview

In considering the proposed merger from the perspective of ratepayers, the greatest risks and benefits involve the impact of the merger on customers' rates. In this case, the rate impact question revolves around two issues, neither of which is directly before us: the ratemaking treatment of the acquisition premium and the next incentive rate plan for CMP. While neither issue is ripe for decision, together, they are central to in determining whether the proposed merger is in the public interest.

Acquisition premiums create a serious dilemma for regulation, in part due to the circularity that they present. The premium is the additional amount over book value, which the acquirer offers to existing shareholders to induce them to sell their shares. The value of a utility to a potential acquirer is the present value of the revenue stream which the buyer anticipates receiving. But if rates are set based upon the buyer's cost of acquiring the firm, then by making a high offer, the buyer simultaneously raises the rates that will be charged to the monopoly customers. The logical result of automatically including the acquisition premium in rates is that the offering price will rise to the point where rates are set at the same level that an unregulated monopoly firm would charge its customers. Such an outcome is clearly undesirable as a matter of both law and economics.

While this simple logic suggests that we should ignore any acquisition premium for purposes of ratemaking, that approach could, if adopted uncritically, lead to higher costs and rates. As we noted some years ago:

Experience ... shows that significant cost savings can be achieved in certain merger situations. In such cases, ratepayers may be better served by a policy that provides some incentive to shareholders to merge. In such cases, if the record shows that the customers of the surviving utility will realize benefits of efficiency gains, then the utility might be entitled to recover some of its costs in excess of net book value.

*Bangor Hydro-Electric Company and Stonington and Deer Isle Power Company, Joint Application to Merge Property, Franchises and Permits and for Authority to Discontinue Service, Docket No. 87-109, (Nov. 10, 1987)(Stonington).*

Energy East is paying \$29.50 per share for CMP, which is approximately 77% more than the net book value of CMP common stock. For accounting purposes, this will result in a substantial amount of goodwill booked on CMP's balance sheet.<sup>15</sup> Energy East states that it intends to amortize the goodwill for accounting purpose over 40 years, resulting in an annual charge of about \$10 million, depending on the actual level of goodwill.

In general, a utility's accounting for a particular item has no bearing on how we would treat the item for ratemaking purposes, and that is certainly true in the present context. Moreover, Energy East is not asking for any statement from us that some or all of the premium will be allowed in rates, but only that it has a reasonable opportunity to recover it from net savings. That said, the issue remains before us in four contexts.

First, generally, a utility keeps its books in conformance with Generally Accepted Accounting Principles (GAAP) unless the Commission, or some other regulatory body such as the FERC, takes action that implies some different

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<sup>15</sup> Energy East estimates that this would result in goodwill of approximately \$470 million, although the actual figure will undoubtedly be somewhat lower as a result of revaluing the non-utility holdings of CMP Group.

treatment. For example, if we were to issue an order stating that under no circumstances would we allow any portion of the acquisition premium in rates, then CMP might be forced to write-off the goodwill immediately. Energy East has requested that we not rule out the possibility of recovering the premium.

Second, the amount of goodwill is likely to be large enough so that if CMP is unable to recover it from ratepayers, either directly in rates or indirectly through keeping a portion of the efficiency savings which result from the merger, it could significantly harm CMP's, and ultimately Energy East's financial position. This would be harmful if it caused an unreasonable reduction in capital and/or O&M budgets, forced management to focus exclusively on short-run earnings, or caused difficulty in attracting capital.

Third, if the acquisition premium were included in rates, it is large enough that it could swamp any merger efficiency savings, resulting in higher rates.

Finally, Energy East has proposed that we institute a new incentive ratemaking plan that is tied to the acquisition premium in two ways. First, the rate plan would allow CMP to avoid a rate case for a number of years (seven years in the ARP 2000 proposal). Under its proposal, rates would be set largely ignoring any merger savings and CMP would then use some or all of the savings to offset the acquisition premium. Second, under the ARP 2000 proposal, the acquisition premium would be an explicit component of the earnings sharing formula. If actual earnings are above a dead band, a portion of the excess that might otherwise go toward reducing rates (or reducing the size of a rate increase) would be used to offset the amortization of the acquisition premium.

## 2. Analysis

While we have never explicitly invoked the *dicta* from the *Stonington* case, we continue to support the concept we enunciated there. However, the policy is not easy to put into practice, particularly in a case such as this where the source of any merger savings, to say nothing of the magnitude, is speculative at best. On one hand, to the extent that a merger such as this actually results in demonstrable cost savings, it would be reasonable to utilize a portion of those savings to offset the cost of undertaking the merger, including the premium. On the other hand, if that policy is implemented poorly, for example by overestimating the actual cost savings from the merger, then we are inviting potential merger suitors to simply bid the price of a utility up so as to include the full monopoly rent. Such an outcome would be, to state it most simply, a clear dereliction of our public interest responsibilities.

Thus, we will not rule out allowing Energy East to include some level of the acquisition premium in a future rate request upon a clear and demonstrable showing that net savings are greater than the premium. We will, however, take this opportunity to offer some insight into how we would analyze such a request. We expect that we would consider two factors.<sup>16</sup>

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<sup>16</sup> A related issue which was not explored in this case is the question of whether any premium allowed in rates should be limited to the difference between the acquisition price and the market price of the stock immediately before the merger was publicly announced. This is sometimes referred to as the "control premium" because it represents the additional value, over the market price of the stock, which the acquiring firm paid to gain control and, therefore, to obtain any synergies. If a request for recovery of the premium were to come before us, we would also consider whether the control premium, rather than the total premium was appropriate. See e.g. the Mass. DPU Merger Guidelines, PUR 155 P.U.R. 4<sup>th</sup> 320, \_\_\_\_ (1994).

First, as we stated in *Stonington*, in order to allow recovery of some or all of an acquisition premium, there must be a clear showing of efficiency savings from the merger, which is not an easy task. The record in this case contains numerous assertions, particularly by Petitioners and Energy East that efficiency gains are difficult to quantify before the fact, essentially because of the need to forecast the costs of the newly merged entity. On the other hand, efficiency gains may be similarly difficult to estimate after the fact, because one would need to compare the actual costs of the merged entity with the forecast or expected costs that would have been incurred had the merger not gone forward. This task will become increasingly difficult over time. Energy East is proposing to amortize the acquisition premium over 40 years. Long before that, say within 10 years, it may be completely impossible to develop any reasonable estimate of merger efficiencies. Thus, there will be an increasingly difficult burden on Energy East to demonstrate that savings are indeed the result of the merger as time passes.

Second, once a reasonable estimate of merger savings has been developed, we would need to consider whether the Maine ratepayers should be responsible for the full amount of the premium. Energy East witnesses have testified that they expect that the merger will produce efficiency benefits at both CMP and NYSEG, Energy East's utility subsidiary in New York. We would need to consider whether it would be reasonable to charge Maine ratepayers for the full amount of any premium which was producing savings elsewhere in the Energy East family but not benefiting Maine ratepayers. In its brief, Petitioners argue against this approach for three reasons. First, they argue that it is inconsistent with GAAP, although they

concede that GAAP does not bind the Commission for ratemaking purposes. Second, they argue that so long as there is no “net harm to ratepayers” it is sensible to allow the full adjustment to be charged to Maine ratepayers. While the issue is not squarely before us, we are not persuaded by Petitioners’ argument at this time. If, for example, two-thirds of the gross benefits of the merger flow to New York customers, and one-third flow to Maine customers, we could accept the proposition that Maine should be liable for one-third of the costs. On the other hand, under Petitioners’ approach, it is possible that the Maine efficiencies could precisely offset the full acquisition adjustment and that one hundred percent of the net benefits would therefore flow to New York customers and/or to stockholders. This appears unreasonable. Finally, the Petitioners are concerned that such an approach would intrude on the jurisdiction of the New York Public Service Commission (NYPSC), “which has the responsibility to determine the effect on NYSEG’s earnings of synergies created by Energy East mergers.” While we appreciate the Petitioners’ concern for the NYPSC’s jurisdiction, their argument is unpersuasive. The NYPSC has authority to allocate NYSEG’s net benefits between NYSEG ratepayers and EE stockholders. We do not see how any action we might take would influence any decision the NYPSC might wish to make.

We note that we may not have to decide on a precise acquisition adjustment to be included in rates. CMP and Energy East both state that they would prefer a long term incentive rate plan which would provide an opportunity to recover the premium, or at least a portion of it, largely without need to include the premium explicitly in the rate setting formula. In fact, this case is now before us in Docket No. 99-666. However, that case will not be decided until well after the conclusion of this case

D. Risks, Rates, and ARP 2000

Fundamentally, deciding this case requires that we consider the possible benefits and risks of the proposed merger, weighing one against the other. As we have suggested, the risks are fairly well defined, although it is difficult to place a dollar value upon them. Somewhat surprisingly, it has been at least as hard to place a value on the potential cost savings that the merger might provide.

Our most basic task is to ensure that rates will not be higher as a result of the merger. There appear to be three ways one might demonstrate that electric rates are likely to be no higher as a result of a merger:

- 1 Estimate the savings from the merger directly,
- 2 Describe a plan for reducing costs as a result of the merger, for example by determining which operational areas offer potential for benefits and the processes by which these might be achieved, or
- 3 Adopt a rate plan which produces lower rates (or at least not higher rates) than a similar plan which would be adopted absent the merger.

As discussed above, the record in this case does not include either estimates of the cost savings nor anything approaching a plan to produce those savings. Arguably, CMP's ARP 2000 filing in Docket No. 99-666 is an attempt to use the third approach to demonstrate that the merger is in the public interest. However, that case has not even begun and thus does not, at this time provide any basis on which we can conclude that rates are likely to be lower, or at least not higher, if the merger goes forward.



For example, under ARP 2000, CMP proposes that we institute a seven year incentive mechanism under which rates will increase at the overall rate of inflation less a productivity offset which begins at 1.00% in 2001, rising at 0.25% per year until it reaches 1.75% in 2004, and then holding at that level for through 2006, the last year for an increase under the plan. One might argue that the increases in the productivity level above 1.00%, the level of the offset under the current ARP, represent merger savings and demonstrate that the merger provides lower rates than would exist without the merger. But while this argument may be plausible, it is, at this stage, far from demonstrably true.

In fact, making such a demonstration will require a full scale review within the Docket 99-666 proceeding. If, for example, we were to conclude that a productivity offset of 1.50% per year were reasonable for a stand-alone CMP, we would per force also to conclude that the merger, coupled with ARP 2000 would result in higher, not lower rates and would be forced to reject it.

In other words, until such time as the ARP 2000 proposal has been fully reviewed, we are unable to conclude that the merger will result in lower rates or that the benefits of the merger are likely to exceed, or even offset the risks which the merger entails.

E. Conclusion

This case presents us with a very difficult decision. Because the merger creates fairly well defined risks for Maine electricity consumers, we can only approve it if we find it likely that offsetting benefits, in the form of lower electric rates, will compensate for these increased risks. Unfortunately, the record, as it sits before us,

does not allow us to be confident that we can expect benefits adequate to offset the risks. This leaves us to choose between two possible resolutions to this case.

Reduced to its essence, CMP argues that merger savings are likely but the magnitude is uncertain and that the right solution is to approve the merger but through future ratemaking decisions – they suggest ARP 2000 – make certain that ratepayers have the benefits of lower rates after the merger than they would see if the merger were not approved.<sup>17</sup> However, as we have already noted, we are not able, at this time, to determine that the ARP 2000 rate proposal will, in fact, produce lower rates for customers as CMP asserts.

**[Examiners Note:** The Advisors have developed two alternative conclusions for the Commission to consider.]

### **Alternative 1**

We can approve the merger, however, because we are confident that we can set rates in the future that will be lower than they would be without the merger, regardless of whether savings materialize. This action of assuring lower rates is necessary to offset the risks of the merger discussed above. We note that this is consistent with CMP's proposal in that its ARP 2000 proposal purports to flow benefits to ratepayers regardless of whether savings materialize. While the ARP 2000 case is not currently ripe for decision, the incentive mechanism we adopt will result in lower rates than would otherwise occur and Energy East shareholders will bear the risk that actual savings will be lower than expected. This, coupled with enhanced performance

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<sup>17</sup>CMP's ARP 2000 proposal is conditioned upon the consummation of the merger. This clearly implies that, at least in the Company's view, the rates they propose

standards, should be adequate to insure continued high quality service. In addition to this rate setting condition, other conditions are necessary to protect the interests of ratepayers as described in Section VII.

## **Alternative 2**

In developing its case, CMP had to choose between two strategies – demonstrating a reasonable likelihood of savings or proposing a rate plan that would yield benefits to ratepayers sufficient to outweigh the risks to which ratepayers would be exposed. CMP suggests that ARP 2000 is the second approach, but it did not file its proposal in adequate time or as part of this case, to allow us to consider what benefits, if any, it provides to ratepayers to offset the risks. As a result, we must deny the petition, although our denial is without prejudice. CMP may refile its request with a fuller demonstration of merger savings or, if CMP wishes, we could continue to process the ARP 2000 proceeding. In the course of considering ARP 2000, we would consider the likely level of future revenue requirements for the merged Company and, by extension, the likelihood that synergies will occur that are sufficient to offset the financial effect of the acquisition premium. If, at that time, it appears likely that an ARP will be able to protect the interests of ratepayers, we will revisit our decision here. In the mean time, however, the petition is denied without prejudice.

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reflect savings that would only be attainable from synergies achieved through the merger.

**VII. CONDITIONS**

Section 708 (2) (A) states that the Commission has the authority to impose

such terms, conditions or requirements as, in its judgment, are necessary to protect the interests of ratepayers. These conditions shall include provisions which assure the following . . . .

The statute then lists nine conditions,<sup>18</sup> including one (number 9: "that neither ratepayers nor investors are adversely affected by the reorganization") that is almost identical to the general approval standard. As we explained in our *Bell Atlantic* Order, we do not view the attachment of conditions as a requirement of the statute. Although the statute provides that "these conditions shall include provisions which assure the following . . . , " the preceding sentence indicates that the Commission has the discretion to attach such conditions as it believes appropriate under the circumstances. Where

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<sup>18</sup> Section 708 provides that these conditions must assure that:

1. The Commission will have reasonable access to books, records, documents and other information relating to the utility or any of its affiliates;
2. The Commission will have all reasonable powers to detect, identify, review and approve or disapprove all transactions between affiliated interests;
3. The utility's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, will not be impaired;
4. The ability of the utility to provide safe, reasonable and adequate service will not be impaired;
5. The utility will continue to be subject to applicable laws, principles and rules governing the regulation of public utilities;
6. The utility's credit will not be impaired or adversely affected;
7. The Commission must impose reasonable limitations on the total level of investment in non-utility business;
8. The Commission must have reasonable remedial power, including the ability to order divestiture of or by the utility if necessary to protect the interest of the utility, ratepayers or investors;
9. Neither ratepayers nor investors may be adversely affected by the reorganization.

the Commission cannot find that the reorganization will be in the interests of ratepayers and stockholders in the absence of conditions, it must impose appropriate conditions. If the Commission has found that a reorganization is in the interests of ratepayers and stockholders even absent conditions, it does not necessarily follow that it should refrain from imposing a condition if that condition will more nearly ensure that the Commission's conclusion was correct. *Bell Atlantic* at 13.

The intervenors in this proceeding all recommended that the Commission disapprove this merger. However, in the event that the Commission does approve the merger, the intervenors proposed certain conditions to provide the protections required by 35-A M.R.S.A. § 708. In addition, we consider additional conditions that may be necessary to assure these protections. We will discuss each of the proposed conditions.

A. Merger Conditions

1. Service Quality Standards

The IECG proposed that if the merger is allowed, CMP should continue to be bound by the existing ARP service quality standards. However, the IECG proposed that the financial penalties associated with non-compliance should be increased, with graduated penalties for continuing non-compliance. Further, the IECG recommended that if the standards are violated, CMP should be prohibited from paying dividends to Energy East until the standards are achieved.

CMP indicated that the Commission should make its service quality expectations known, but that the exact mechanisms should be determined in the rate case. Specifically, the Company asserted that the IECG's proposed dividend

restriction would be micromanaging and disproportionate to the risk of service quality problems.

We agree with CMP that restricting the dividends CMP can pay would be micromanaging by this Commission. We have historically left dividend payment decisions to utility management. We see no overriding reason that we should modify this policy now. However, we want to be very clear that we would find any erosion in service quality unacceptable. Further, we do not agree that there should be no penalty mechanism for service quality issues until the conclusion of the next rate case. Therefore, we will extend the ARP service quality standards until a new mechanism is set, presumably in the next rate case proceeding. CMP should continue to track its performance under the ARP service quality standards contained in Attachment 6 of the ARP Stipulation approved by the Commission in Docket No. 92-345 (II), *Central Maine Power Company, Proposed Increase in Rates* (Jan. 10, 1994). It should file a report on its progress in July 31, 2000 and every 6 months thereafter until we establish a new ARP. We also make it clear that to the extent the Company violates these standards, we retain the right to open an investigation into whether penalties or sanctions are appropriate. The right of the Commission to impose appropriate penalties or sanctions is an explicit condition of the approval of this merger.

We also put CMP on notice that we expect to closely examine service quality standards in the ARP 2000 proceeding. Given the risks involved in this merger we will likely strengthen the standards relative to those in the existing ARP. We note that the standards in NYSEG's current rate plan are

considerably more stringent than CMP's and we expect to consider whether moving to, or beyond, the NYSEG level would be appropriate.

2. Capital Spending Targets

The IECG suggested that we establish targets for capital expenditures for the first five years after the merger to prevent Energy East from cutting CMP's O&M and capital expenditure budgets in a way that could compromise reliability. The IECG suggests that this could be done by requiring investments in its delivery system and facilities either equal to the levels invested prior to the merger (adjusted for inflation) or equal to the Company's 5-year capital budget, if that capital budget was prepared previous to the merger announcement. The CSE recommended that CMP be required to maintain staff and facilities sufficient to assure that the service quality in the period 2000 through 2010 will be the same as it was from 1998 to 1999. We do not believe such spending targets are necessary.<sup>19</sup> As described above, we expect the Company to maintain its service quality standards but will largely leave the details of how it accomplishes this to the Company's discretion. To the extent reliability problems surface, we intend to impose penalty provisions on the Company necessary to compensate ratepayers from past actions and protect ratepayers from future actions. However, in order to keep informed on this issue, we will require the Company to file its annual budget each December and to explain any significant reductions in either the capital or O&M budgets. We may remove this condition when a rate plan is considered.

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<sup>19</sup> We included such targets as a condition of the NYNEX/Bell Atlantic merger. However, we subsequently lifted it a year later. Docket No. 94-123, *Public Utilities Commission, Investigation into Regulatory Alternatives for the New England Telephone and Telegraph Company d/b/a NYNEX*, Order (Mar. 17, 1998).

3. Commission Access to Book and Records

As a condition to the merger, the Commission must have access to the books and records of Energy East and all its CMP affiliates to allow for reasonable and timely access by the Commission staff and its agents. 35-A M.R.S.A. § 708(2)(A)(1). This will help us to monitor activities to determine whether any improper affiliate transactions or other abuses are occurring.

Energy East needs to provide this access in a reasonable and timely manner. At the Commission's request, this access must be available in Maine. Should we choose to conduct a review of detailed information supporting a CMP request or transaction, the original documentation must be available to us.

4. Commission Jurisdiction over Energy East and Affiliates

Although it was not raised by any of the parties, 35-A M.R.S.A. § 708(2)(A)(1) and (2) are clear that the Commission must have the ability to "detect, identify, review and approve or disapprove all transactions between affiliated interests" and that the Commission must have "reasonable access to books, records, documents and other information relating to the utility or any of its affiliates." Therefore, to assure this protection, we will require as a condition of the merger that Energy East and any of its affiliates must be willing to be subject to the Commission's jurisdiction for discovery purposes and must be willing to be a party to any proceeding deemed necessary by the Commission, in its sole discretion.

5. Commission's Authority to Order CMP Divested

35-A M.R.S.A. § 708(2)(A)(8), specifically allows the Commission, "the power, after notice to the utility and all affiliated entities of the issues to be



determined and the opportunity for an adjudicatory proceeding, to order divestiture of or by the utility in the event that divestiture is necessary to protect the interest of the utility, ratepayers or investors.” We specifically condition approval of the merger on the ability of the Commission in the future to require divestiture of CMP if necessary, in a manner consistent with § 708(2)(A)(8). We include this as a condition because of the risks present by this merger discussed above.

6. Acquisition Premium

As we discussed in Section 6, we would only allow recovery of some or all of the acquisition premium through rates if there is a clear showing that (a) efficiency savings from the merger exist, (b) the overall effect of the merger, including the impact of the premium is to reduce rates, and (c) that Maine ratepayers are receiving a reasonable portion of the net savings from the merger. The burden of making that clear showing would rest squarely upon the utility.

At the November 2 hearing there was a rather lengthy discussion in which Energy East testified that it sought a “reasonable opportunity”, but not a guarantee that it could recover the acquisition premium. (Tr. G-191 to G-201) We consider the three criteria listed above to provide a reasonable opportunity and, from the testimony of Mr. Jasinski and Mr. Rude, believe that Energy East would agree. For that reason, we will condition the merger on the acceptance by Energy East that these conditions do, in fact, represent a reasonable opportunity and that it would not seek recovery of the premium except to the extent that those conditions are met.

7. Proposed Conditions Not Adopted

a) Intervenor proposals not adopted

Several of the intervenors proposed additional conditions that should be attached to any approval of the merger. We do not find implementation of the following conditions necessary to approve the merger. We will briefly discuss each proposed condition and the reason we have rejected it.

The CSE proposed that CMP/Energy East shareholders should be required to pay for a public education campaign designed to educate consumers regarding the fuel types and the emissions associated with the generation they are purchasing. They also sought a requirement that each monthly utility bill from March, 2000 through February, 2001 include a copy of the full Uniform Disclosure Label regarding the generation that consumers are purchasing. We reject these suggestions as we do not see how such conditions bear on the proposed merger. These conditions relate to industry restructuring, not the proposed merger. The proposed merger should have no effect whatsoever on the fuel sources or emissions associated with generation that is provided to consumers. Further, we believe the current requirements and voluntary efforts for consumer education regarding industry restructuring are adequate.

The CSE also proposed that the Commission require CMP to devote one page of each month's bill to information on how consumers can save electricity, to update and redistribute a 1992 informational pamphlet on the subject and that to provide evidence that all energy management measures have been installed whenever CMP seeks to increase T&D capacity. We reject these conditions as well. Generally, the level of energy management that a utility is required to achieve is set by

state energy policy and this Commission. The CSE has not demonstrated that the proposed merger will have any effect on this level or the utility's ability to achieve it. Further, we would not require the utility to achieve *all* potential energy management measures prior to expanding T&D capacity rather only those that are cost effective. To do otherwise could be very expensive and cost ineffective.

The CSE has also suggested that CMP/Energy East be required to maintain a Maine-based outage call center for the next five years and that the elderly or disabled have the ability to immediately reach a live person. We presume that the concern with a non-Maine based outage call center would be delays and difficulties in resolving outages and service quality issues. We believe this will be addressed through the service quality requirements. CSE's second point is an issue that is not directly related to the merger. If elderly and disabled individuals need easy access to a live person, this could be a problem that exists even without the merger and should be addressed through a change to the consumer protection rules, not as part of this proceeding.

The Friends of the Coast has urged the Commission to withhold approval of the merger until CMP and Energy East demonstrate that they have adequately informed themselves regarding the Maine Yankee decommissioning and waste disposal issues and are prepared to address the public's concerns in these areas. We reject this proposal. It is the NRC's responsibility to determine the appropriateness of transferring the Maine Yankee license to Energy East.

The IECG proposed that if the Commission approves the merger, it should condition its approval on the ability to revisit these conditions if the

Public Utilities Holding Company Act (PUHCA) is repealed. We find this unnecessary. As described above, we have made clear that consistent with Section 708(2)(A)(8), the Commission maintains the power to make remedial changes necessary to protect the interest of the utility, ratepayers or investors. If the merger occurs and PUHCA is subsequently repealed and such changes are necessary, we will make them.

IECG also asks that the Commission condition the merger on acknowledgement by Energy East of the Commission's findings in Docket No. 97-580. We do not believe such an explicit condition is necessary. CMP will remain subject to all Maine statutes and previous Commission orders. Energy East, as CMP's parent holding company, will be required to ensure that CMP is managed in a manner that conforms with Maine law and Commission orders and precedent. Energy East witnesses acknowledged this during the hearing<sup>20</sup> and we see no need to condition what is so obviously required.

B. CMP's Request to Lift Certain Conditions Imposed in Docket No. 97-930

1. Restriction on Investments

For the following reasons, we find that the investment limits imposed on CMP Group in Dockets 97-930 should be lifted as requested by CMP. Our reasoning is generally consistent with the positions of the Company and the IECG. Assuming that all of Energy East's proposed acquisitions (including Berkshire Energy Resources) close, its total capitalization will be between \$4.1 and \$4.8 billion (See

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<sup>20</sup> For example, Energy East witnesses testified Energy East it did not have a marketing affiliate in Maine and it did not intend to establish one as it understood this to be prohibited by 35-A M.R.S.A. § 3205(6).

Merrill Lynch Report dated July 1, 1999), compared to CMP's pre-divestiture capitalization of approximately \$1.2 billion and its recent capitalization of roughly \$801 million. In either case, Energy East's common equity balance will be slightly over \$1.9 billion and its common equity ratio will be somewhere between 41% and 48%. OPA 01-02. The combination of the size of the new Energy East, the holding company structures being employed and Energy East's focus on acquiring low-risk transmission and distribution (or "pipes and wires") businesses allows us to look favorably on the Petitioner's request.

We are not persuaded by the OPA's argument that new business risks require maintenance of the investment limits. When we approved the \$240 million investment limit in Docket No. 97-930, we effectively allowed CMP the opportunity to invest up to 20% of its pre-divestiture capital structure in non-utility ventures. At CMP's current capitalization, this would be roughly a 30% limit. If we were to place such a limit on the Energy East holding company it would be on the order of 5% to 6% of total capital (at \$4.1B to \$4.8B in total capital). We agree with CMP that retaining the \$240 million limit on CMP Group, Inc. (intermediate holding company) could give Energy East the incentive to make investments in other states rather than Maine. CMP Group, Inc. will not issue new common equity on its own and it will quite likely be unable to borrow new debt since it will not be able to offer its utility assets as collateral without our approval. We do not believe it is appropriate to reset the investment limit at 20% to 30% of Energy East's total capitalization, since this would effectively be a number close to, or exceeding, 100% of CMP Group, Inc.'s capitalization.

## 2. Limits on Debt Issuances

For many of the same reasons noted in Section VII, B.1, above, we agree with the Petitioners and the IECG that the 50% limitation on debt imposed in Docket No. 97-930 is no longer practical. The total size of the organization, the fact that we cannot directly limit the borrowing activities of Energy East, the corporate focus on low-risk transmission and distribution businesses and the possibility that we could discourage future investment in Maine by keeping such a requirement in place causes us to eliminate this requirement. As we noted above, CMP Group will not be in a position to issue common equity and it is unlikely to be in the position of issuing new debt because it will not be able to offer utility assets as collateral without our approval. If, in time, CMP Group, Inc.'s unregulated subsidiaries become creditworthy enough to support their own borrowing, this will not be a detriment to CMP's Group's utilities. The unregulated subsidiaries, with higher business risk profiles, will be able to borrow less (i.e. will be required by lenders to have higher equity ratios than an electric utility) than the electric utility on a relative basis. The credit markets will, in effect, limit the leverage ratio of CMP Group, Inc. and its unregulated subsidiaries even in the event that all of them grow substantially.

We also are aware that the credit rating agencies have consistently stated in the past two years that the "wire and pipes" transmission and distribution businesses have the lowest business risk profiles in the energy industry. They have also stated that lower business risks allow companies pursuing those strategies to have higher leverage ratios (and lower cash flow & interest coverage ratios) while maintaining their credit ratings. Energy East's corporate target of a 40% common equity ratio in the

future does not appear unreasonable based on studies presented in Docket No. 97-580 (Phase I) and Docket No. 97-596. We are, again, unable to determine that some harm will come to CMP's utility ratepayers if the condition limiting debt to 50% of total capital is lifted. In the future, when we calculate the CMP utility's capital structure, cost of equity and cost of capital, we will use the divisional cost of capital approach and not consider the capital structure of CMP Group, Inc. or Energy East and therefore ratepayers will not be harmed.

3. Royalty Payments for Use of CMP Name by CMP Gas

Petitioners ask that CMPNG no longer be required to pay royalties for use of the CMP name. It claims that the terms of the stipulation that require the payment should be set aside in light of recent statutory changes and CMPNG's more remote connection to CMP under the proposed new structure. OPA objects to eliminating the stipulation's provisions.

We must examine the background leading up to the stipulation and events since then to reach a decision on this issue. On May 1, 1998, we approved the creation of CMP Natural Gas (referred to then as "GasCo") as a joint venture of CMP Group, Inc. and New York State Electric and Gas Co., Docket No. 98-077, *Central Maine Power Company, Request for Approval of Reorganization and of Affiliate Interest Transactions and Sale of Assets in Connection With Gas Ventures*. Our approval was conditioned on the application of Chapter 820's requirements if the CMP name was used in the name of the gas subsidiary:

Use of the CMP identity in the marketing or advertising constitutes the use of good will under the definition in Chapter 820(2)(F). Chapter 820 includes a presumption that the good will is valued at 1% of the total capitalization of the

affiliate or 2% of the gross revenues of affiliate, whichever is less. The rule specifically allows a utility to present evidence that the value of the good will is less. Chapter 820 (4) (C).<sup>21</sup>

After the Order was issued, the gas affiliate decided to use the name CMP Natural Gas. In response to the Docket No. 98-077 royalty requirement, CMP entered into a stipulation with the Public Advocate. They filed their Agreement for Commission approval on May 7, 1998. The Agreement allows CMP to convey its corporate name and goodwill for a one-time payment of \$500,000, to be made upon the earlier of: (i) six years from the date the affiliate is formally created, or (ii) 120 days after the conclusion of the first calendar year in which the affiliate earns its authorized return on equity. The stipulation also provides an alternative payment method in the event

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<sup>21</sup> Chapter 820(4)(C) provides:

C. Value of Goodwill. The value of the utility's goodwill used by an affiliate must be determined as follows:

1. The value of goodwill to be paid annually by an affiliate must be determined on an annual basis for an initial 3-year period beginning on the date that the affiliated transaction is approved or upon the date that the affiliate will commence use of the goodwill, whichever is later.

2. At the end of the initial 3-year period, the Commission shall reexamine the value of goodwill to be paid by the affiliate for the use of goodwill for the next 3 years.

3. The value of goodwill shall be presumed to be, and calculated as, 1% of the total capitalization of the affiliate, or 2% of the gross revenues of the affiliate, whichever is less, and shall be paid annually by the affiliate. Where the name of the utility has been used in Maine by the utility for less than 3 years, the value of goodwill shall be presumed to be zero. At the end of six years from the date the affiliated transaction is approved or upon the date that the affiliated commences use of the goodwill, whichever is later, the value of goodwill is zero.

4. Any party may present evidence that the value of goodwill is greater than, or less than, the presumptions stated in paragraph 3. . . .



CMPNG's return on equity (net income) does not exceed \$5 million in any of its first five years. The Commission approved the stipulation by Order issued on June 10, 1998.

During its last session, the Legislature amended 35-A M.R.S.A. § 715 (effective September 18, 1999). This section now provides that Chapter 820 "may not establish a presumption with regard to the value of goodwill used by an affiliated interest regulated by the Commission." P.L. 1999, ch. 158, sec. 2. This provision requires the Commission to eliminate Chapter 820's *presumption* about goodwill where two utility affiliates are involved. It does not, however, prohibit the Commission from determining that such royalty payments are appropriate in specific circumstances.

We also find that the amendment does not affect a pre-existing stipulation. CMP chose to enter into a stipulation with OPA. The Agreement did not even use the presumption contained in the rule. Instead, the parties crafted an alternative method for establishing the royalty payment. CMP did not have to enter such an Agreement. It could have presented evidence to the Commission about the value of the goodwill associated with the CMP name. We plan to amend Chapter 820 to remove the presumption and simply require a utility to make its case on the value of the goodwill. CMP could have done the same in 1998. It chose not to and instead entered into a stipulation with OPA. We will not disturb that stipulation and instead continue to require CMP Natural Gas to comply with its provisions. If CMP Natural Gas chooses to change its name to Energy East Natural Gas then no royalty payment will be owed.

Dated: December 2, 1999

Submitted by,

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Joanne B. Stenneck  
Hearing Examiner

Thomas Austin  
Lucretia Smith  
Angela Monroe  
Mitch Tannenbaum  
Richard Kivela